

January 2008

# DEFENSE CONTRACTING

## Contract Risk a Key Factor in Assessing Excessive Pass-Through Charges



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Highlights of [GAO-08-269](#), a report to congressional committees

## Why GAO Did This Study

One-third of the Department of Defense's (DOD) fiscal year 2006 spending on goods and services was for subcontracts. Concerns have been raised among DOD auditors and Congress about the potential for excessive pass-through charges by contractors that add little or no value when work is subcontracted. To better understand this risk, Congress mandated that GAO assess the extent to which DOD may be vulnerable to these charges. This report examines (1) DOD's approach to assessing the risk of excessive pass-through charges when work is subcontracted, (2) the strategies selected private sector companies use to minimize risks of excessive pass-through charges when purchasing goods and services, and (3) DOD's interim rule to prevent excessive pass-through charges.

GAO's work is based on analysis of 32 fiscal year 2005 DOD contract actions at 10 DOD top contracting locations and discussions with DOD acquisition policy, audit, and contracting officials, including Defense Contract Audit Agency (DCAA) and Defense Contract Management Agency (DCMA) staff. GAO also interviewed nine selected private sector companies with diverse contracting experience.

## What GAO Recommends

GAO is recommending that DOD guidance to implement its interim rule requires that assessments of pass-through charges be risk-based and involve DCAA and DCMA as appropriate. DOD concurred with the recommendations.

To view the full product, including the scope and methodology, click on [GAO-08-269](#). For more information, contact Ann Calvaresi Barr at (202) 512-4841 or [calvaresibarra@gao.gov](mailto:calvaresibarra@gao.gov).

## DEFENSE CONTRACTING

### Contract Risk a Key Factor in Assessing Excessive Pass-Through Charges

## What GAO Found

Although no specific criteria exist for evaluating contractor value added, DOD contracting officials generally rely on tools in the Federal Acquisition Regulation (FAR) to assess the risk of excessive pass-through charges when work is subcontracted. For the 32 selected contract actions GAO reviewed, DOD contracting officials generally applied these tools to their assessments. The degree of assessment depended on whether the contract was competed and whether the contract type required the government to pay a fixed price or costs incurred by the contractor. When using full and open competition, contracting officials assessed contractor value added based on the technical ability to perform the contract, but did not separately evaluate cost since market forces generally control contract costs, potentially minimizing the risk of excessive pass-through charges. However, when using noncompetitive contracts, contracting officials were required to evaluate more detailed cost information in assessing value added, as market forces did not determine the contract cost. For example, for a \$3 billion noncompetitive contract for an Air Force satellite program, contracting officials assessed detailed cost or pricing data that included subcontractor costs, and received DCAA and DCMA support to negotiate lower overall contract costs. However, assessing contractor value added is especially challenging in unique situations where requirements are urgent in nature and routine contracting practices may be overlooked. Related GAO work and DOD audits on contracts awarded for Hurricane Katrina recovery efforts found multiple layers of subcontractors, questionable contractor value added, increased costs, and lax oversight.

The selected private sector companies GAO interviewed rely heavily on acquisition planning, knowledge of supply chain, and managing contractual relationships to minimize risk of excessive pass-through charges when purchasing goods and services. They seek to optimize competition to minimize overall contract costs, and several companies indicated that they prefer fixed-price competitive arrangements. In addition, some form collaborative business relationships with contractors and subcontractors that provide greater insight into their supply chains and costs—a challenge DOD continues to face. When using other than fixed-price contracts, they recognize the financial risks and ensure proper oversight and accountability. As GAO has reported in the past, DOD's use of riskier contracts, such as time-and-materials contracts, has not always ensured good acquisition outcomes.

DOD recently issued an interim rule requiring a contract clause in all eligible contracts, which allows it to recoup contractor payments that contracting officers determine to be excessive. The rule also requires detailed information from contractors on their value added when subcontracting costs reach 70 percent or more of total contract cost. However, the rule alone will not provide greater insight into DOD's supply chain and costs—information companies told us they use to mitigate excessive costs. Further, contracting officials indicated the need for guidance to ensure effective implementation and consistent application of tools in the FAR as appropriate.

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## Abbreviations

ANC	Alaska Native Corporation
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DOD	Department of Defense
FAR	Federal Acquisition Regulation
SARA	Services Acquisition Reform Act
USACE	U.S. Army Corps of Engineers

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United States Government Accountability Office  
Washington, DC 20548

January 25, 2008

Congressional Committees:

In fiscal year 2006, the Department of Defense (DOD) spent over \$294 billion to procure goods and services from prime contractors, with more than one-third of this spending for awards to subcontractors. However, concerns have been raised among federal auditors and Congress about the potential for DOD to overpay contractors that subcontract work and add little or no value.<sup>1</sup> To help minimize this risk, Congress mandated that DOD issue regulations on preventing these pass-through charges. It also required GAO to assess the extent to which DOD may be vulnerable to excessive pass-through charges.<sup>2</sup> Specifically, we (1) determined DOD's current approach to assessing the risk of excessive pass-through charges when work is subcontracted, (2) identified the strategies selected private sector companies use to minimize risks of excessive pass-through charges when purchasing goods and services, and (3) assessed DOD's interim rule to prevent excessive pass-through charges.

To determine DOD's current approach to assessing the risk of excessive pass-through charges when work is subcontracted, we reviewed and analyzed the Federal Acquisition Regulation (FAR) and the Defense Federal Acquisition Regulation Supplement (DFARS). We also discussed these regulations with DOD acquisition policy, audit, and contracting officials. This included Defense Contract Audit Agency (DCAA) and Defense Contract Management Agency (DCMA) staff to discuss their roles in reviewing and managing contracts. To obtain a broad perspective on the processes in place to determine costs and extent of subcontracting, we met with contracting staff from 10 of the top contracting locations across DOD. At those locations, we reviewed and analyzed available documentation for a nongeneralizable sample of 32 DOD contract actions awarded in fiscal year 2005.<sup>3</sup> Using DOD's procurement information

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<sup>1</sup> Pass-through charges are contractor charges for the costs associated with subcontracting work.

<sup>2</sup> Section 852 of the John Warner National Defense Authorization Act Fiscal Year 2007, Public Law No. 109-364.

<sup>3</sup> Contract actions consisted of base contracts, task orders placed against existing contracts, and contract modifications.

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system—DD350 database—we selected actions that had subcontracting plans and small business contracts over \$10 million. While our sample cannot be generalized to all DOD contract actions, it represented a range of products and services, levels of competition, types of contracts, and dollar value across DOD military services. We discussed these contracts with the responsible contracting officials and examined the degree to which available tools in acquisition regulations were used in assessing the value added of contractors. Because no specific criteria exist for assessing value added, we did not measure the adequacy of the contracting officials' assessments. To understand how DOD approached the assessment for contracts where much of the work was subcontracted, we reviewed recent GAO and DOD audits and reports on questionable value added and costs as well as discussed the reports with responsible DOD audit officials. We also looked at practices outside of DOD to identify the strategies nine selected companies use to minimize the risk of excessive pass-through charges when purchasing a range of goods and services. We also reviewed findings and recommendations of the Acquisition Advisory Panel's 2007 report on commercial practices.<sup>4</sup> We reviewed previous GAO reports and issues raised in various GAO acquisitions forums and interviewed officials from industry groups such as the Professional Services Council and the Coalition for Government Procurement. To assess DOD's recent efforts to prevent excessive pass-through charges, we reviewed its interim rule responding to the congressional mandate and discussed it with DOD officials. We conducted this performance audit from March 2007 to December 2007 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. A more detailed discussion of our scope and methodology is provided in appendix I.

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<sup>4</sup> This panel was authorized by Section 1423 of the Services Acquisition Reform Act of 2003 (commonly known as the SARA panel). Pub.L.No. 108-136. The panel's statutory charter was to review and recommend any necessary changes to acquisition laws and regulations as well as governmentwide acquisition policies with a view toward ensuring effective and appropriate use of commercial practices and performance-based contracting. Some topics examined included the use of commercial practices in federal contracting, performance-based contracting, performance of acquisition functions across agency lines of responsibility, and governmentwide contracts.

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## Results in Brief

DOD assesses the risk of excessive pass-through charges when work is subcontracted as part of its routine contracting practices. While no specific criteria exist for evaluating contractor value added, DOD contracting officials rely on tools in federal and DOD acquisition regulations. For the 32 selected contract actions we reviewed, DOD contracting officials generally applied these tools to their assessments. However, the extent to which these tools were applied depended on the contract risk—that is, whether the contract was competed and whether the type of contract required the government to pay a fixed price or costs incurred by the contractor. According to the contracting officers we spoke with, competitive fixed-price contracts may reduce the risk of excessive costs to the government. As a result, they did not perform the same level of assessment as they did on contracts with greater risk—such as those awarded noncompetitively or without fixed prices. When using full and open competition, contracting officials assessed contractor value added based on the technical ability to perform the contract, but did not separately evaluate costs for value added since market forces generally control proposed contract cost, potentially minimizing the risk of excessive pass-through charges. However, when using other than full and open competition,<sup>5</sup> contracting officials were required to evaluate more detailed cost information in assessing value added to minimize risk of excessive pass-through charges, as market forces did not determine the contract cost. For example, in a \$3 billion noncompetitive contract for an Air Force satellite program, contracting officials required detailed cost and pricing data that included subcontractor costs to assess the contractor's value added, and received DCAA and DCMA support to negotiate lower overall contract costs. In another case—an \$863 million cost-reimbursement competitive contract for Navy support services—while detailed cost information was considered in source selection, the technical capability of the contractor to manage multiple tiers of subcontractors was a significant factor in assessing its value added. However, conducting assessments of the value added by contractors is especially challenging under unique situations where requirements are urgent in nature and routine contracting practices may be overlooked. For example, related GAO work and DOD audits on contracts awarded for Hurricane Katrina recovery efforts found multiple layers of subcontractors, questionable value added by contractors, increased costs, and lax oversight.

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<sup>5</sup> For purposes of this report, we refer to other than full and open competitive procedures as noncompetitive.



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To minimize the risk of excessive pass-through charges when procuring goods and services, private sector companies we interviewed indicated that they rely heavily on acquisition planning, knowledge of supply chain, and managing contractual relationships. As part of their acquisition planning, company officials told us that they seek to optimize competition to control overall contract costs. Several companies indicated that they enter into fixed-price competitive arrangements and form collaborative business relationships with contractors and subcontractors that provide greater insight into their supply chain and costs—a challenge DOD continues to face. According to several companies, using other than fixed-price contracts is sometimes necessary based on the requirements. When doing so, however, they recognize the financial risks and devote resources to ensure proper oversight and accountability. As we have reported in the past, DOD's use of riskier contracts, such as time-and-materials contracts, has not always ensured good acquisition outcomes or a prudent expenditure of taxpayer funds.

In April 2007, DOD issued an interim rule that allows it to recoup contractor payments that contracting officers determine to be excessive on all eligible contracts. The rule specifically requires contracting officers to insert a clause in these contracts that allows recovery of excessive payments and contractors to report detailed information on their value added when subcontracting reaches 70 percent or more of the total contract cost. While the rule aims to provide contracting officers with more information on contractor value added, it alone will not provide greater insight into DOD's supply chain and costs—information that companies told us they use to mitigate excessive costs. In addition, while the rule is not yet final, contracting officials we spoke to indicated the need for guidance on how to effectively implement the rule since they were not clear what more they should be doing beyond applying tools in the FAR and DFARS. This would ensure that contracting officers, particularly newer and less experienced staff, consistently apply federal acquisition tools in conducting their assessments of contractor value added and take into account contract risk when determining the degree of assessment needed, documenting assessments, and involving DCAA and DCMA as appropriate.

We are recommending that as DOD finalizes its rule on avoiding excessive pass-through charges and develops guidance for assessing contractor value added, DOD (1) require contracting officials to take contract risk into account when determining the level of assessment needed, (2) require assessments of contractor value added be documented, and (3) involve DCAA and DCMA in facilitating assessments as appropriate. In written

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comments on a draft of this report, DOD concurred with the recommendations and noted planned and current actions underway that are directly responsive. DOD's comments are included in appendix III.

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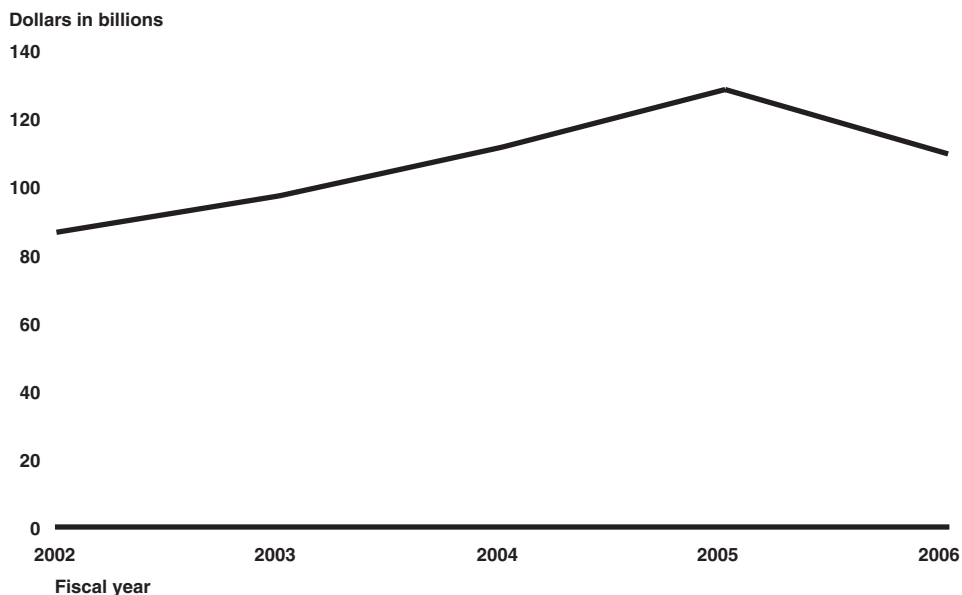
## Background

DOD is increasingly relying on contractors to provide a range of mission-critical support from operating information technology systems to providing logistics support on the battlefield. These contractors are responsible for managing contract performance, including planning, placing, and administering subcontracts as necessary to ensure the lowest overall cost and technical risk to the government. Although total subcontract awards from DOD contracts decreased 15 percent from fiscal year 2005 to 2006, total subcontract awards have increased by 27 percent, from \$86.5 billion in fiscal year 2002 to \$109.5 billion in fiscal year 2006.<sup>6</sup> (see fig. 1).

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<sup>6</sup> The annual subcontracting data were obtained from the Office of the Under Secretary of Defense, Office of Small and Disadvantaged Business Utilization, for fiscal years 2002 through 2006. We did not independently test the reliability of the data obtained from this office, which relies on DOD contractors to report this subcontract information semiannually on Standard Form 295 (SF295).

**Figure 1: Total Subcontract Awards from DOD Contracts, Fiscal Years 2002 through 2006**



Source: GAO analysis of DOD-provided data.

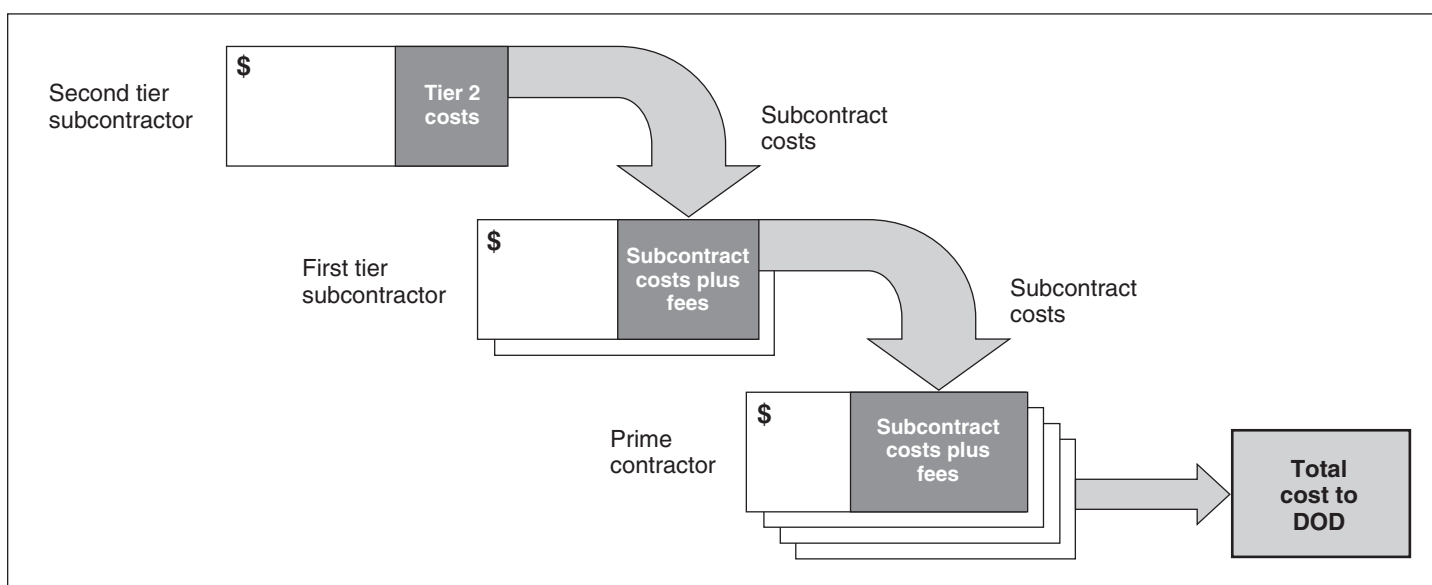
Notes: All dollar figures have been converted to fiscal year 2007 dollars. DOD officials were not able to explain the decrease from fiscal year 2005 to fiscal year 2006.

While subcontracting plans submitted by contractors are required for most contracts over \$550,000,<sup>7</sup> this information is reported only for first tier subcontracts.<sup>8</sup> Historically, DOD has limited insight into costs associated with using multiple layers of contractors to perform work. Figure 2 depicts how lower tier's costs become part of the higher tier's and prime contractor's overall costs.

<sup>7</sup> Subcontracting plans are required for most contracts over \$550,000 or \$1 million for construction contracts. FAR 19.702(a)(1)&(2); 13 CFR § 125.3(a). Subcontracting plans are not required (1) from small businesses; (2) for personal service contracts; (3) for contracts or contract modifications performed outside any state, territory, or possession of the United States, the District of Columbia, and the Commonwealth of Puerto Rico; or (4) for modifications of contracts within the general scope of the contract that do not contain the clause FAR 52.219-8, Utilization of Small Business Concerns. FAR 19.702(b)

<sup>8</sup> For purposes of this report, we refer to each level of subcontracting as a layer or tier.

**Figure 2: Example of Costs with Subcontract Layers**



Source: GAO analysis.

## Risks of Excessive Pass-Through Charges Are Assessed through Routine Evaluations of Contractor Value

DOD contracting officials generally rely on tools in the FAR and DFARS in assessing the risk of excessive pass-through charges when work is subcontracted. For the 32 selected contracts we reviewed, when there was full and open competition, contracting officials assessed contractor value added based on the technical ability to perform the contract, but did not need to separately evaluate costs for value added as market forces generally control the proposed contract cost. However, contracts with greater risk—such as those awarded noncompetitively or without fixed prices—require contracting officers to consider more than the technical ability to perform the work in assessing value added. We found that conducting assessments of contractor value added is especially challenging in unique circumstances, such as when requirements are urgent in nature and routine contracting practices may be overlooked.

## DOD Generally Relies on Tools in Acquisition Regulations to Assess Contractor Value Added

The FAR and DFARS contain requirements for contracting officials when entering into contractual relationships that are intended to help ensure the best value for products and services. Contracting officers have wide latitude to exercise business judgment when applying these regulations. While no specific criteria exist for contracting officers to use in evaluating contractor value added, several key elements in acquisition regulations,

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however, provide them with a mix of tools to gain insight into how prime contractors intend to do the work and the associated costs, including the role and costs of subcontracting.<sup>9</sup>

- **Acquisition planning** is key to determining contract requirements, level of competition available based on market research, and the appropriate contract vehicle to be used based on level of risk.<sup>10</sup>
- **Solicitation procedures** allow contracting officers to select the prospective contractor that represents the best value to the government.<sup>11</sup>
- **Contract pricing** is used to determine price reasonableness for the contract, including subcontracting costs.<sup>12</sup>
- **Contract administration** is intended to obtain a variety of audit and administration services to hold contractors accountable for operating according to their proposals.<sup>13</sup>

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## Presence of Competition and Type of Contract Generally Guide the Use of Assessment Tools

According to DOD contracting officials and based on our review of selected contracts, assessments of contractor value added are typically driven by contract risk—the presence of competition and whether the type of contract requires the government to pay a fixed price or costs incurred by the

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<sup>9</sup> Appendix II provides more detail on these key elements.

<sup>10</sup> FAR 16.103 (b). A firm-fixed-price contract is ordinarily used when the risk involved is minimal or can be predicted with an acceptable degree of certainty. When a reasonable basis for firm pricing does not exist, other contract types should be considered. FAR 16.104(j). If the contractor proposes extensive subcontracting, a contract type reflecting the actual risks to the prime contractor should be selected.

<sup>11</sup> FAR 15.101. In different types of acquisitions, the relative importance of cost or price may vary. In acquisitions where the requirement is clearly definable and the risk of unsuccessful contract performance is minimal, cost or price may play a dominant role in source selection. The less definitive the requirement, the more development work required, or the greater the performance risk, the more technical or past performance considerations may play a dominant role in source selection.

<sup>12</sup> When prices are based on adequate price competition, no other information is generally needed. In other cases, more information may be needed from the prime contractor as well as any subcontractors. See FAR 15.403-3, Subcontract Pricing Considerations.

<sup>13</sup> Contracting officers can request further assistance in contract administration from DCMA reviews and DCAA cost audits, which include evaluation and surveillance of contractor management systems that relate to subcontractors.

contractor. When using full and open competition, the value added by the prime contractor was determined by its technical ability to perform the contract, but generally contracting officers did not do a separate detailed evaluation of cost to determine value added. DOD contracting officials told us that competitive fixed-price contracts allow the market to control overall contract value, which provided them with reasonable assurance of the contractor's value added and potentially minimizing the risk of excessive pass-through charges. When using noncompetitive contracts, however, the market forces did not control contract cost and required contracting officers to consider—in addition to cost—the technical ability to perform the work. Specifically, DOD contracting officials noted that noncompetitive as well as other than fixed-price contracts require additional oversight and administration, including more detailed information to conduct the assessment of contractor value added and minimize the risk of excessive pass-through charges. For the 32 selected contracts we reviewed, 16 were awarded noncompetitively, with 7 of those on a cost-reimbursement basis and 2 on a time-and-materials basis. (see table 1) .

**Table 1: Number of Selected Contracts by Competition and Risk**

Full and open competition			Noncompetitive		
Fixed-price (2)	Cost-reimbursement (11)	Time-and-materials (3)	Fixed-price (7)	Cost-reimbursement (7)	Time-and-materials (2)
Lower risk			Higher risk		

Source: GAO analysis of DOD contract data and the FAR.

DOD contracting officials noted that fixed-price contracts incentivize prime contractors to keep overall contract costs low—to include any subcontract costs—as they will have to absorb cost overruns under such contracts. In reviewing two fixed-price competitive contracts for Air Force space systems,<sup>14</sup> acquisition planning and market research up-front provided insights into reasonable prices as well as identified the best-qualified suppliers to do the work. Air Force officials stated that because competitive contracts are often proposed by a team of contractors—the prime plus the subcontractors—market pricing extends to subcontractor costs as well. In discussing the two contracts, these officials added that fixed prices lowered the government's risk of increased costs. As a result,

<sup>14</sup> Contracting officials estimated that over 90 percent of the contracts at two Air Force commands we visited are competitive.

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the contracting officials said that in assessing the prime contractor's value added, they focused more on the technical capabilities—rather than cost—to ensure contractors were responsive in meeting the mission.

Contracting officials told us that contracts awarded noncompetitively decrease their assurance of price reasonableness since there is no basis of comparison through competition.<sup>15</sup> Therefore, they rely on other pricing tools contained in the FAR and DFARS. These tools assist the contracting officers in obtaining more detailed information to provide reasonable assurance of contractor value added and potentially minimize the risk of excessive pass-through charges.<sup>16</sup> Our review of contract files also revealed the role that DCAA and DCMA played in reviewing cost information in several of the 16 noncompetitive contracts we reviewed and helping to negotiate subcontract costs.

- For the Air Force's estimated \$3 billion satellite program contract, DCAA reviewed the certified cost and pricing data that the contractor was required to provide. The required data included not only the contractor's costs but a detailed description of the efforts and costs of each subcontractor, including subsidiary companies. The contracting officer judged the proposed costs based on results of audit reports and a technical evaluation. Because of the high dollar value and complexity of this contract, the program office required the prime contractor to submit cost data reports at the conclusion of each effort and cost performance reports to provide insight into the prime contractor's and subcontractor's cost and schedule data. Additionally, DCAA and DCMA helped to negotiate individual subcontracts and, in some cases, achieve lower overall costs.
- The Army similarly relied on DCAA and DCMA assistance on a \$1 billion fixed-price contract for a family of heavy tactical vehicles. The Army did not pursue full and open competition, citing the lack of industry response, thus requiring contracting officers to gain more insight into prime contractor and subcontract costs to assess contractor value added and minimize the risk of excessive pass-through charges. The Army used a teaming arrangement that allowed the contracting command, DCAA, DCMA, and the contractor to evaluate, discuss, and negotiate the costs. Each cost element was

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<sup>15</sup> In fiscal year 2006, DOD reported that 37 percent of its contracts were awarded as other than full and open competition.

<sup>16</sup> FAR Subpart 15.4.

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mutually agreed upon, resulting in a negotiated price list. Contracting officials told us that these negotiated prices applied to subcontracts for vehicle parts as well, preventing overcharges by lower-tier subcontractors.

- For an \$11 million Navy contract for fighter aircraft support, DCMA provided an evaluation of prime contractor and subcontractor costs for certain services. In prenegotiation discussions with the Navy, DCMA described the technical evaluation of the contractor's cost proposal, providing a cost summary of what was proposed by the contractor and what was recommended during the technical evaluation. For one portion of the contract, the evaluators questioned the direct labor hours proposed by the prime contractor for managing the project because most (if not all) the actual work would be done by subcontractors. The DCMA technical evaluator found the hours proposed to be excessive, raising questions about the prime contractor's value added relative to the costs. Documentation in the contract file stated that although the prime contractor believed the hours proposed were fair, it agreed to a 25 percent reduction in the hours.

In addition to the presence of competition, the risk associated with contracts in which the government pays based on costs incurred also affects the degree to which contracting officers assess contractor value added and potentially minimize the risk of excessive pass-through charges. These contracts, which include cost-reimbursement and time-and-materials contracts, increase DOD's need to ensure appropriate surveillance during performance to provide reasonable assurance that efficient methods and effective cost controls are used. Because of the risks involved, the FAR directs that these contracts should be used only when it is not possible at the time of award to estimate accurately the extent or duration of the work or to anticipate costs with any reasonable degree of confidence.<sup>17</sup> Of the selected contracts we reviewed, 18, or 56 percent, were cost-type contracts with 11 noncompetitively awarded. Contracting officials told us that under these arrangements, although competition increases the assurance of reasonable prices and controls contract cost, the absence of a fixed price requires them to take additional steps to obtain other information to assess the roles and costs of prime contractors and subcontractors, which assists in evaluating contractor value added.

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<sup>17</sup> FAR 16.301-2 and FAR 16.301-3 describe limitations on the use of cost-reimbursement contracts. FAR Part 16.601(c) describes the application of time-and-materials contracts.



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For example, a task order awarded under a \$3 billion Army multiple award contract, which reimbursed the contractor based on the cost of its time and materials, demonstrated the risk associated with these contracts.<sup>18</sup> Under this multiple award contract, eight prime contractors competed for task orders, with one of the contractors identifying over 75 subcontractors in its proposal. On the task order we reviewed, for engineering services, most of the work was subcontracted. Contracting officers stated that because the contract was awarded on a time-and-materials basis, the government was particularly vulnerable to the prime contractor charging more than it paid for its subcontractor since at this time prime contractors could charge for subcontract labor at the prime's rate and keep any difference between its rate and the subcontractor's. While the prime contractor was not required to submit certified cost or pricing data, it was required to provide a task execution plan that described the specific duties of both the prime contractor and the subcontractor, including the fees they were charging the government to manage the subcontractor. The Army evaluated the plan and determined that the number of hours and rates proposed by the prime contractor were reasonable based on the data provided. We have previously reported that for some time-and-materials contracts, DOD paid more than actual costs for subcontracted labor.<sup>19</sup> To minimize this risk with time-and-materials contracts, a new DOD regulation set forth different rules about how prime contractors are to be reimbursed for subcontracted labor to ensure that prime contractors do not charge the government higher rates than those charged by subcontractors.<sup>20</sup>

In our review of other cost-type contracts, DOD gained insight into value provided by the prime contractor in determining price reasonableness. The cost or pricing data in some cases provided the contracting officer with added insight by breaking out costs of the prime contractor and major subcontractors by the work they were to perform. Further, in some cases, DCAA questioned the proposed subcontractor costs and provided

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<sup>18</sup> A multiple award indefinite delivery, indefinite quantity contract occurs when an agency enters into a contract with two or more sources under the same solicitation. These contracts provide for an indefinite quantity, within stated limits, of products or services during a fixed period. Agencies place orders for individual requirements under these contracts.

<sup>19</sup> GAO, *Defense Contracting: Improved Insight and Controls Needed over DOD's Time-and-Materials Contracts*, [GAO-07-273](#) (Washington, D.C.: June 29, 2007).

<sup>20</sup> DFARS 216.601(e).

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an estimate for the contracting officer to use in negotiating a more reasonable price to ensure best value. For example, in a \$92 million Army contract for the redesign of a chemical demilitarization facility, DCAA questioned the surcharges applied to certain subcontractor costs and recommended lower rates. The contractor accepted the lower rates, reducing the overall cost to the Army.

According to several contracting officials, as prime contractors assign subcontractors more critical roles to achieve a mission, the increased need for detailed cost information is coupled with the need for more insight into the technical capabilities of the subcontractors. Because cost is not always the primary criterion used to determine best value, technical capabilities can also be evaluated to determine the role of the prime contractor when work is subcontracted.<sup>21</sup> We found that cost was not always ranked as the highest factor in reviewing source selection criteria for five cost-type contracts. For one example—an \$863 million Navy contract for support services related to a destroyer—the technical evaluation determined the ability of the prime contractor and multiple tiers of subcontractors to perform the work. While detailed cost information was obtained from the prime contractor and considered in the source selection, its ability to consolidate and manage efforts that had previously been conducted under five separate contracts was a particularly significant factor in evaluating the contractor's value added. In another example—a \$2.9 billion Navy contract for a major weapons system—given the size of the contract and magnitude and complexity of work involved, the contracting officer required greater insight into how the prime contractor intended to subcontract. As a result, the contracting officer modified the contract to increase requirements for the prime contractor to obtain consent to subcontract. The contracting officer told us that although prime contractors are ultimately responsible for managing their subcontractors, DOD still needed to maintain a certain level of insight into subcontracting, given the increased role.

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<sup>21</sup>FAR 15.1—Source Selection Processes and Techniques—provides considerable flexibility to the buying activity in evaluating competitive proposals. An agency can obtain best value in negotiated acquisitions by using any one or a combination of source selection approaches. The process permits trade-offs among cost or price and noncost factors, such as technical capabilities, when it is in the best interest of the government to consider awarding to other than the lowest-priced offeror.

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## Unique Circumstances Can Drive Contracting Arrangements That Carry Greater Risk of Excessive Pass-Through Charges

Some unique contracting arrangements that are noncompetitive or where requirements are urgent in nature carry greater risk of excessive pass-through charges and pose challenges in conducting assessments of contractor value added. This was the case with a contract we reviewed that had been awarded to an Alaska Native Corporation (ANC) firm through a small business development program. In addition, related GAO work and DOD audits on contracts awarded for Hurricane Katrina recovery efforts found multiple layers of subcontractors, questionable value added by contractors, increased costs, and lax oversight.

Through the Small Business Administration's 8(a) program,<sup>22</sup> DOD and other federal agencies can award sole-source contracts to ANC firms for any dollar value. The Small Business Administration requires agencies to monitor the percentage of work performed by the 8(a) firms versus the percentage performed by their subcontractors to ensure that small businesses do not pass along the benefits of their contracts to subcontractors. The "limitations on subcontracting" clause in the FAR requires that for 8(a) service contracts with subcontracting, the firm must incur at least 50 percent of the personnel costs with its own employees (for general construction contracts, the firm must incur at least 15 percent of the personnel costs).<sup>23</sup> However, for one contract we reviewed that was awarded to an ANC firm, contracting officials had failed to include the required FAR clause in the contract and other contracting officials we spoke to were unsure who should be monitoring compliance—findings consistent with our past work on ANC 8(a) contracts.<sup>24</sup>

For an Army logistics support services cost-reimbursement contract for \$54 million awarded to an ANC noncompetitively, substantial variations in

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<sup>22</sup> The Small Business Administration's 8(a) program is one of the federal government's primary means for developing small businesses owned by socially and economically disadvantaged individuals. This program allows the government to award contracts to participating small businesses without competition below certain thresholds.

<sup>23</sup> FAR 52.219-14, Limitations on Subcontracting. In the case of a contract for supplies (other than procurement from a nonmanufacturer in such supplies), the concern will perform at least 50 percent of the cost of manufacturing the supplies, not including the cost of materials.

<sup>24</sup> While representing a small amount of total federal procurement spending, obligations for 8(a) contracts to ANC firms increased from \$265 million in fiscal year 2000 to \$1.1 billion in 2004. GAO, *Contract Management: Increased Use of Alaska Native Corporations' Special 8(a) Provisions Calls for Tailored Oversight*, [GAO-06-399](#) (Washington, D.C.: Apr. 27, 2006); GAO, *Alaska Native Corporations: Increased Use of Special 8(a) Provisions Calls for Tailored Oversight*, [GAO-07-1251T](#) (Washington, D.C.: Sept. 19, 2007).

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workload created too much cost risk to make it a fixed-price contract. According to the contracting officer, usually with a scope of work this large and varied, the contract lends itself to subcontracting. When asked about the level of insight into how the ANC would use subcontracted support, the contracting officer responded that this was challenging since small businesses are not required to submit subcontracting plans. In reviewing the base contract, we found that it did not contain the required clause that limits subcontracting. We brought this to the attention of the contracting officer, who told us that although he was not aware of any subcontracting, the clause should have been included and it was an oversight. Several other contracting officials we spoke to said they were unsure of whose responsibility it is to monitor compliance with the subcontracting limitations under these 8(a) contracts. They recognized that they should be doing more to monitor compliance. By not ensuring compliance with the limits on subcontracting requirement, there is an increased risk that an inappropriate degree of the work is being done by large businesses, raising questions about the value added by the ANC firm.

According to contracting officials we spoke with, assessing the value added by a prime contractor is especially challenging in emergency situations, where requirements are critical and urgent in nature, such as those for recovery from Hurricane Katrina. We have similarly reported that the circumstances created by these situations can make it difficult to balance the need to deliver goods and services quickly with the need for appropriate controls. Our past work has cautioned, however, that limited predictability must not be an excuse for poor contracting practices. In some cases, the response to Hurricane Katrina suffered from inadequate planning and preparation to anticipate requirements for needed goods and services.<sup>25</sup> The scale of operations and the government's stated inability to provide program management after Katrina drove the decision to award contracts with large scopes of work that, in certain cases, led to multiple layers of subcontractors and increased costs.

GAO's past work in reviewing orders and contracts for the Katrina recovery effort found that the U.S. Army Corps of Engineers (USACE) disclosed increased costs associated with multiple supplier layers. In reviewing orders and contracts for portable public buildings in Mississippi, which were awarded in 2005, we found that USACE ordered 88 buildings

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<sup>25</sup> GAO, *Agency Management of Contractors Responding to Hurricanes Katrina and Rita*, [GAO-06-461R](#) (Washington, D.C.: March 2006).

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that were purchased and sold through two to three layers of suppliers, resulting in prices 63 percent to 133 percent higher than manufacturers' sales prices. In one example, 45 of the 88 portable public buildings were purchased from a contractor who in turn purchased the buildings from a distributor, who in turn purchased them from another distributor, who had purchased the 45 buildings from the manufacturer. Each layer added an additional fee, resulting in USACE agreeing to a price that was 63 percent higher than the manufacturer's price.

DOD auditors have noted additional concerns in some Katrina contracts they reviewed. For example, a November 2006 Army Audit report stated that unclear requirements for four post-Katrina debris removal contracts awarded by USACE—for \$500 million each with an option for an additional \$500 million—resulted in prices renegotiated in unfavorable circumstances.<sup>26</sup> According to the report, the urgency to award contracts quickly did not give USACE contracting personnel sufficient time to develop a well-defined acquisition strategy—one that defined desired outcomes and risks related to the acquisition to ensure contracts were structured in the government's best interest. Contracting officials were less diligent about complying with acquisition regulations regarding best value contracts and reasonable pricing. Fixed-price contracts were renegotiated at higher prices without the benefit of a DCAA review. USACE's decision to use four large contracts also resulted in multiple tiers of subcontractors to accomplish the work, with each tier adding costs. Post-award audits performed by DCAA found substantial overcharges by the debris contractors.

USACE officials we spoke with noted that they have revised the acquisition strategy to structure the size and scope of contracts to maximize competition and minimize subcontractor tiers. New contracts will have reduced performance periods to ensure that prices reflect the existing conditions. While USACE previously set production rates in its contracts, it did not measure them during the performance of the contract. USACE officials further stated that under the revised strategy, they will negotiate the production rate and measure the contractor's ability to maintain it. To ensure price reasonableness of proposed prices, USACE plans to request DCAA to assist the contracting officer in reviews of competitive proposals and in negotiations. According to the officials, these

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<sup>26</sup> U.S. Army Audit Agency, *Debris Removal Contracts: U.S. Army Corps of Engineers*, Audit Report: A-2007-0016-FFD (Washington, D.C.: Nov. 9, 2006).

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revisions to USACE's acquisition strategy were designed to address concerns related to prime contractors passing work on to subcontractors and increasing costs to the government without adding value.

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## Selected Private Sector Companies Rely on Several Shared Approaches to Minimize The Risk of Excessive Pass-Through Charges

Selected private sector companies we interviewed had several strategies in common for minimizing the risk to them of excessive pass-through charges when purchasing goods and services. These companies focus resources on acquisition planning and knowledge of their supply chains and costs—challenges DOD continues to face. They also seek to optimize competition, preferring fixed-price competitive arrangements. According to several companies, they recognize the financial risks of other types of contracts, such as time-and-materials, and enter into them with proper oversight and accountability. As we have previously reported, DOD's use of these riskier contracts has not always ensured good acquisition outcomes and prudent expenditure of taxpayer dollars. In addition, company officials we interviewed told us that continuous and close management of the contractual relationship is critical to minimizing risks of excessive costs.

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## Private Sector Companies Focus on Acquisition Planning and Knowledge of Supply Chain

The contracting officials we spoke with at selected private sector companies told us that to avoid unnecessary pass-through charges when purchasing goods and services, they devote attention to planning acquisitions. Some companies told us that they invest in teams of experts and consultants to define contract requirements and then structure contracts based on the complexity of the acquisition. For example, one company described the use of cross-functional teams to obtain input on information technology, purchasing, quality, and other internal expertise. Having such information assists in developing comprehensive project acquisition plans and clear and stable requirements. One company seeks input from its engineers to develop a set of criteria based on the product or service acquisition. Officials from another company told us they will determine the optimum number of subcontracts required to procure a particular product or service and group them based on the requirements and need to subcontract. One company contracting official told us that it is an "expensive fishing expedition" when the requirements are not clearly defined, as it limits the company's ability to enter into fixed-price competitive contracts and can increase its vulnerability to excessive costs. Private sector firms that spoke before the Acquisition Advisory Panel—established to review federal acquisition laws and regulations on a number of issues—also described a vigorous acquisition planning phase when buying services. These firms invest time and resources necessary to

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clearly define requirements first, allowing them to achieve the benefits of competition.

According to some company contracting officials, they use rigorous market research and requests for information to develop a range of potential suppliers and cost and pricing data. Having this information on their supply chain allows these companies to minimize the risk of excessive pass-through charges. To gain additional information into costs, some companies work in a collaborative environment with contractors and subcontractors. However, they indicated that in these types of arrangements, companies have to be willing to share information openly and communicate their concerns and needs to achieve best value from the contractual relationship.

Company officials told us that clearly defined requirements contribute to their ability when purchasing goods and services to enter into fixed-price contracts that lower costs and mitigate the risks of unnecessary charges relative to value added by the prime contractor. While the vast majority of their contracts are competitive fixed-price type contracts, some companies noted that the use of other contracts is sometimes necessary. Companies we met with recognize the financial risks involved and enter into them only with proper oversight and accountability. Buyers from companies who spoke before the Acquisition Advisory Panel also noted that when they enter into time-and-materials contracts, for example, they “endeavor to maintain tight controls over the contracting process, costs, and levels of effort.”

Prior GAO work has found that DOD has been challenged in adequately planning many of its major acquisitions. In 1992, GAO identified DOD contract management as high-risk due to long-standing concerns in planning, execution, and overseeing acquisition processes.<sup>27</sup> We have reported that to produce desired outcomes, DOD and its contractors need to clearly understand acquisition objectives and how they translate into a contract’s terms and conditions. Likewise, we have reported that obtaining reasonable prices depends on the benefits of a competitive environment, yet we have found cases where DOD failed to adequately define contract

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<sup>27</sup> GAO’s high-risk designation is given to major programs and operations that need urgent attention and transformation in order to ensure that our national government functions in the most economical, efficient, and effective manner possible. It also emphasizes programs that are at high risk because of their great vulnerability to fraud, waste, abuse, and mismanagement.

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requirements, making it difficult to hold DOD and contractors accountable for poor acquisition outcomes. Moreover, participants at a October 2005 GAO forum related to Managing the Supplier Base noted that DOD faces challenges in maintaining insight into its supply chain and recognized the importance of promoting competition in managing multiple tiers of suppliers.<sup>28</sup> In addition, our recent work on DOD's use of time-and-materials contracts noted that contracting and program officials frequently failed to ensure that these contracts were used only when no other contract type was suitable. DOD officials cited speed and flexibility as the main reasons these contracts were used, and we reported inconsistencies in the rigor with which DOD monitored contractor performance, as called for in time-and-materials contracts.<sup>29</sup>

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### Private Sector Companies Closely Manage Contractual Relationships to Control Costs

Company officials we interviewed told us that continuous management of the contractual relationship is critical to minimizing risks of excessive costs. The specific management practices used by companies generally include establishing clear contract terms and periodic evaluations to monitor performance. Subcontractor management practices include the use of clear contract terms to guide the relationship and ensure both parties understand each other's needs. Some companies told us that the type of contract arrangement depends on the product or service and some contract terms may include more detail than others. According to one company, the level of detail of information requested also depends on the product or service procured, size of the procurement, and complexity of the work to be performed. This company told us that in such cases it has requested information on all parties who would be performing the work, down to the fifth level. In other cases it may retain the right to renegotiate the contract to ensure it is receiving the best price throughout the contractual agreement. Typically, both parties agree to renew the contract as long as the performance and benefit goals are being met.

Company officials stressed the importance of having performance monitoring systems to ensure that the prime contractor's value added relative to subcontractor costs is being met. For example, one company

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<sup>28</sup> GAO, *Highlights of a GAO Forum: Managing the Supplier Base in the 21st Century*, [GAO-06-533SP](#) (Washington, D.C.: Mar. 31, 2006).

<sup>29</sup> GAO, *Defense Contracting: Improved Insight and Controls Needed over DOD's Time-and-Materials Contracts*, [GAO-07-273](#) (Washington, D.C.: June 29, 2007).



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we interviewed told us that it periodically checks prices in the marketplace against cost information provided by the supplier. Similarly, another company emphasized the need to continuously check prices against the market, since similar to DOD, it does not have insight below the first-tier subcontractors. Some companies we interviewed also emphasized the importance of periodically evaluating and assessing the contractor's value added relative to the costs and the need for continuing, changing, or ending the contract relationship.

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## Contracting Officials Lack The Guidance and Insight Needed to Effectively Implement DOD's Interim Rule

DOD recently issued an interim rule that allows it to recoup contractor payments that contracting officers determine to be excessive on all eligible contracts. The rule requires detailed information from the prime contractor on value added when subcontracting reaches 70 percent or more of the total contract. While the rule aims to provide contracting officers with more information, it will not provide greater insight into DOD's supply chain and costs. Further, while the rule is not yet final, contracting officials indicated to us that guidance is needed to ensure effective and consistent implementation in assessing contractor value added, particularly for newer and less experienced contracting staff.

Congress required DOD in the Fiscal Year 2007 National Defense Authorization Act to prescribe regulations on excessive pass-through charges, which are defined in the act as charges (overhead and profit) for work performed by a contractor or subcontractor that adds no, or negligible, value. In April 2007, DOD issued an interim rule to require a contract clause that provides audit rights and cost recovery should these excessive pass-through charges occur.<sup>30</sup> The rule also requires specific disclosure by a contractor that intends, or subsequently decides, to subcontract most of the work. Specifically, the contractor is to identify in its proposal the percentage of effort it intends to perform, and the percentage expected to be performed by each subcontractor under the contract, task order, or delivery order, or if a decision to subcontract comes after award, the contractor must notify the contracting officer in writing. Under the interim rule, prime contractors are required to inform a contracting officer of the value added that they are providing when

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<sup>30</sup> 72 Fed. Reg. 20758 (April 26, 2007). Excessive Pass-through Charges. As of December 2007, DOD was in the process of responding to public comments and revising its interim rule.

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subcontract costs exceed 70 percent of the total contract value.<sup>31</sup> While the rule may enhance insight into contractor value added under these circumstances, it will not address DOD's challenges in obtaining insight into its supply chain and costs—key information needed to mitigate risk of excessive pass-through charges according to companies we interviewed.

In addition, DOD has not developed guidance for contracting officers to use in implementing the rule. Specifically, it lacks guidance that addresses contract risk associated with presence of competition, contract type, and unique circumstances where requirements are urgent in nature. As we found during our contract review, these are key risk factors to take into account when determining the degree of assessment needed, not necessarily the percentage of subcontracting alone. However, contracting officers have wide latitude in exercising judgment on how to apply these tools. While contracting officers we met with were generally applying these tools in conducting their assessments of contractor value added for the selected contract actions we reviewed, they indicated that guidance—particularly for newer and less experienced staff—would help ensure the tools are consistently applied and that assessments are properly documented in the contract files. We brought this to the attention of DOD procurement policy officials, who told us that as they develop implementing guidance, they will emphasize that contracting officers need to include contract risk in conducting their contractor value added assessments and document the results.

While the regulation allows contracting officers to recoup charges that they determine to be excessive, it does not specify the roles of DCAA and DCMA in this process. As we found in our contract review and in discussions with contracting officials, these organizations played a key role in assessing cost information. However, contracting officials indicated the importance for newer and less experienced staff to involve DCAA and DCMA as appropriate. We spoke with officials from both of these agencies, who also indicated that they would play a role in implementing this regulation and in assisting contracting officers in determining whether costs are excessive, but they said they had not fully considered the extent or the resources needed. We brought this to the attention of DOD procurement policy officials, who agreed these

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<sup>31</sup> The rule excludes (1) firm-fixed-price contracts awarded on the basis of competition, (2) fixed-price contracts with economic price adjustment awarded on the basis of adequate price competition, (3) firm-fixed-price contracts for the acquisition of a commercial item, or (4) fixed-price contracts with economic price adjustment for the acquisition of a commercial item.

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organizations need to be involved in assisting contracting officers in their assessments of whether pass-through charges are excessive, and as they develop implementing guidance, they will emphasize the involvement of DCAA and DCMA in facilitating the assessments as appropriate.

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## Conclusions

Assessing contractor value added and minimizing the risk of excessive pass-through charges have taken on heightened importance given the increasing role of subcontractors in providing DOD with critical goods and services—especially for emergency situations, where routine contracting practices may be overlooked in an effort to meet urgent requirements. Historically, DOD has lacked insight into subcontractor costs, raising questions about the value added when multiple layers of contractors perform the work. Optimizing competition—an acquisition strategy the private sector companies we interviewed emphasized when purchasing goods and services for their own operations—can minimize DOD’s risk of paying excessive payments since market forces generally control contract cost. However, without insight into the supply chain and associated costs, it is difficult to assess the risk of excessive pass-through charges. While DOD’s new interim rule is a step in the right direction, it by itself will not help contracting officials gain this insight. Further, although we found that contracting officers were generally applying tools in the FAR in conducting assessments of contractor value added for selected contracts we reviewed, implementing guidance for the new rule would help ensure these tools are consistently applied in determining the degree of assessment needed, documenting the assessments, and appropriately involving DCAA and DCMA.

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## Recommendations for Executive Action

As DOD finalizes its rule on preventing excessive pass-through charges and develops implementing guidance to ensure consistency in how contracting officials assess contractor value added, we recommend that the Secretary of Defense direct the Director of Defense Procurement and Acquisition Policy to take the following actions:

- Require contracting officials to take risk into account when determining the degree of assessment needed. Risk factors to consider include whether (1) the contract is competed; (2) the contract type requires the government to pay a fixed price or costs incurred by the contractor; and (3) any unique circumstances exist, such as requirements that are urgent in nature.

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- Require contracting officials to document their assessments of contractor value added in the contract files.
  - Involve DCAA and DCMA in facilitating assessments as appropriate.

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## Agency Comments

We provided a draft of this report to DOD for comment. In written comments, DOD concurred with our recommendations and noted actions planned and underway that are directly responsive. Specifically, DOD anticipates issuing a second interim rule in February 2008 and expects a final rule in August 2008. Once the rule is finalized, DOD intends to provide extensive guidance to supplement the regulation that will cover a range of issues, including those GAO recommended. DOD's comments are reproduced in appendix III.

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We are sending copies of this report to the Secretary of Defense and will make other copies available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report or need additional information, please contact me at (202) 512-4841 or [calvaresibarra@gao.gov](mailto:calvaresibarra@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report were John Neumann, Assistant Director; Barry DeWeese; Yvette Gutierrez-Thomas; Kevin Heinz; Maurice Kent; Julia Kennon; John Krump; and Karen Sloan.



Ann Calvaresi Barr  
Director, Acquisition and Sourcing Management

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*List of Committees*

The Honorable Carl Levin  
Chairman  
The Honorable John McCain  
Ranking Member  
Committee on Armed Services  
United States Senate

The Honorable Daniel K. Inouye  
Chairman  
The Honorable Ted Stevens  
Ranking Member  
Subcommittee on Defense  
Committee on Appropriations  
United States Senate

The Honorable Ike Skelton  
Chairman  
The Honorable Duncan L. Hunter  
Ranking Member  
Committee on Armed Services  
House of Representatives

The Honorable John P. Murtha, Jr.  
Chairman  
The Honorable C. W. (Bill) Young  
Ranking Member  
Subcommittee on Defense  
Committee on Appropriations  
House of Representatives

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# Appendix I: Scope and Methodology

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To determine the Department of Defense's (DOD) approach to assessing the risk of excessive pass-through charges when work is subcontracted, we reviewed and analyzed tools in the Federal Acquisition Regulation (FAR) and the Defense Federal Acquisition Regulation Supplement (DFARS). We met with DOD officials from the Office of the Secretary of Defense, Defense Procurement and Acquisition Policy, Defense Contract Audit Agency (DCAA), Defense Contract Management Agency (DCMA), and contracting officials from 11 DOD contracting locations to discuss these regulations and their approach to assessing the risk of pass-through charges, evaluating contractor value added, and factors that drive these assessments. We selected 10 of these locations, which had some of the highest spending in fiscal year 2005, to visit and discuss specific contracts, policies, and processes related to evaluating contractor value added when work is subcontracted. In addition, while we did not visit the Army Tank and Automotive Command in Warren, Michigan, we obtained contract documents from it for review. While our selection of locations cannot be generalized to the population of all DOD contracting locations, those selected represented each of the military services and represented a variety of goods and services procured. The specific military locations we visited were:

## U.S. Air Force

- Air Force Space Command, Colorado Springs, Colorado
- Air Force 21st Space Wing, Peterson Air Force Base, Colorado Springs, Colorado
- Air Force 50th Space Wing, Schriever Air Force Base, Colorado Springs, Colorado
- Air Force Space and Missile Command, El Segundo, California

## U.S. Army

- U.S. Army Space and Missile Defense Command, Peterson Air Force Base, Colorado Springs, Colorado
- Army Contracting Agency, Fort Carson, Colorado Springs, Colorado
- Army Communications and Electronics Command, Fort Monmouth, New Jersey
- Army Sustainment Command, Rock Island, Illinois

## U.S. Navy

- Naval Sea Systems Command, Washington Navy Yard, District of Columbia
- Naval Air Systems Command, Patuxent River, Maryland.

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At the locations we visited, and to provide a broad perspective on extent to which contracting officials apply existing tools in acquisition regulations in assessing risk of excessive pass-through charges and contractor value added, we analyzed and discussed 32 selected contract actions awarded in fiscal year 2005. These selected actions included base contracts, task orders under contracts, and modifications to contracts. Since DOD's procurement information system—DD350 database—does not contain a specific field for percentage of subcontracting, of all DOD contract actions over \$10 million and had reported submitting a subcontracting plan, we selected a nongeneralizable sample of actions that provided a mix of contract types, levels of competition, dollar values, and goods and services procured. Moreover, we also selected small business contracts over \$10 million. While small businesses are not required to submit subcontracting plans, the dollar value of these actions would have otherwise required them. We relied on data provided in the DD350 database and verified the reliability of the information where practical with contracting officers, contract files at contract locations visited, and through review of contract documents in DOD's Electronic Data Access Web-based system. On the basis of this assessment, we found the DD350 database to be sufficiently reliable for our purposes.

We reviewed and analyzed available documentation for the selected DOD contract actions and discussed these actions with the responsible contracting officials. While our selection of contract actions cannot be generalized to all DOD contracts, those selected represent each of the military services and a number of different contract actions, allowing us to obtain a variety of perspectives from DOD contracting officials. In reviewing and discussing contract files with contracting officials at these locations, we examined factors that drove the need to assess prime contractor and subcontractor costs, guidance and tools available to conduct assessments, and level of insight into subcontracting activity. Included in the contract files and also reviewed were documents from DCAA and DCMA that were used to support the decisions of contracting officials. We met with both of these agencies to discuss their roles in assisting contracting officials. Because no criteria exist for assessing value added relative to costs, our review does not include a determination of whether the DOD contracting officer adequately assessed the value added and costs, but rather the extent to which the contracting officer applied existing tools in the FAR and DFARS. In addition, to obtain additional information on contracts that had been identified as having questionable costs, we also interviewed the Army Corps of Engineers, the Army Audit Agency, and the DOD Office of Inspector General. We reviewed and analyzed documents from these agencies as well as past GAO work to

determine how tools in acquisition regulations were applied in contracts with questionable costs. We also discussed strategies being explored to help mitigate risks of excessive costs on future contracts.

To identify the strategies selected private sector companies use to minimize risk of excessive pass-through charges when purchasing goods and services, we selected nine companies to interview. Our selection of companies was based on diversity in commercial and public sector contracting and a range of goods and services. In the company interviews, we discussed the perspectives and practices for managing and assessing value added relative to prime and subcontractor costs. In addition to the interviews, we reviewed findings and recommendations of the Acquisition Advisory Panel's 2007 report on commercial practices. We also reviewed previous GAO reports and issues raised in various GAO acquisition forums and met with industry associations, such as the Professional Services Council and Coalition for Government Procurement. Table 2 provides a list and description of the companies we interviewed.

**Table 2: Selected Companies and Operations**

Company	Description
Accenture	A consulting firm providing management consulting and technical assistance, and outsourcing services to government and commercial clients.
ALCOA	The world's leading producer and manager of primary aluminum, fabricated aluminum, and aluminum facilities.
IBM	A global leader in business services and computer hardware and software.
John Deere	A leading manufacturer of agricultural equipment, construction and forestry equipment, commercial and consumer equipment.
Miratek	An information technology solution and environmental engineering services small business company with mostly government clients.
Northrop Grumman	A global defense and technology company providing innovative systems, products, and solutions in information and services, electronics, aerospace, and shipbuilding to government and commercial customers worldwide. <sup>a</sup>
Raytheon	A technology leader specializing in defense, homeland security, and other government markets, that provides mission systems integration, and other capabilities in communications and intelligence systems, as well as a broad range of mission support services.



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Company	Description
Science Applications International Corporation	Specializes in scientific, technical, and engineering work. Develops technical solutions and provides systems integration and mission-critical support services to federal, state, local, and foreign governments and private sector customers.
Vangent	The company's markets as well as services include consulting, systems integration, business process outsourcing, and human capital management.

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Source: GAO analysis

<sup>a</sup> GAO also met with the Northrop Grumman Information Technology division that provides commercial information technology services and solutions.

To assess DOD's interim rule to prevent excessive pass-through charges, we reviewed the specific mandate for DOD in Section 852 of the Fiscal Year 2007 Defense Authorization Act. We discussed this requirement with DOD procurement policy officials and reviewed the interim DOD rule on excessive pass-through charges in response to the mandate as well as any changes made based on public comments received. We also spoke to DCAA and DCMA regarding their role in implementing the rule and obtained perspectives from contracting officials we interviewed at the military locations we visited on potential challenges in implementing the rule.

# Appendix II: Key Elements for Contracting Officers in Assessing Contractor Value Added

Element of framework	Description
<b>Acquisition planning</b>	Acquisition planning determines the requirements of the contract, the level of competition available based on market research, and the appropriate contract vehicle to be used.
Defining requirements	Requirements and logistics personnel should avoid issuing requirements on an urgent basis or with unrealistic delivery or performance schedules, since it generally restricts competition and increases prices. Early in the planning process, the planner should consult with requirements and logistics personnel who determine type, quality, quantity, and delivery requirements. (FAR 7.104(b))
Market research	Market research is conducted to determine if commercial items are available to meet the government's needs or could be modified to meet the government's needs. The extent of market research will vary, depending on such factors as urgency, estimated dollar value, complexity, and past experience. Market research involves obtaining information specific to the item being acquired using a variety of resources. The availability or unavailability of items in commercial markets drives the contracting procedures used. (FAR 10.001 and 10.002)
Competition	Contracting officers shall provide for full and open competition through use of competitive procedures that are best suited to the circumstances of the contract action and consistent with the need to fulfill the government's requirements efficiently. (FAR Part 6.101) When adequate price competition exists, generally no additional information is necessary to determine the reasonableness of price. (FAR 15.403-3) Acquisition plans should address when subcontract competition is both feasible and desirable and describe how it will be sought, promoted, and sustained throughout the course of the acquisition. (FAR 7.105(b)(2)(iv))
Type of contract	A wide selection of contract types is available to the government and contractors in order to provide needed flexibility in acquiring goods and services. The objective is to negotiate a contract type and price that will result in reasonable contractor risk and provide the contractor with the greatest incentive for efficient and economical performance. A firm-fixed-price contract, which best utilizes the basic profit motive of business enterprise, shall be used when the risk involved is minimal or can be predicted with an acceptable degree of certainty. However, when a reasonable basis for firm pricing does not exist, other contract types should be considered, and negotiations should be directed toward selecting a contract type that will appropriately tie profit to contractor performance. If the contractor proposes extensive subcontracting, a contract type reflecting the actual risks to the prime contractor should be selected. (FAR 16.1)
<b>Source selection</b>	In different types of acquisitions, the relative importance of cost or price may vary. For example, in acquisitions where the requirement is clearly definable and the risk of unsuccessful contract performance is minimal, cost or price may play a dominant role in source selection. The less definitive the requirement, the more development work required, or the greater the performance risk, the more technical or past performance considerations may play a dominant role in source selection. (FAR Part 15.101)
Cost or price evaluation	Normally, competition establishes price reasonableness. Therefore, when contracting on a firm-fixed-price or fixed-price with economic price adjustment basis, comparison of the proposed prices will usually satisfy the requirement to perform a price analysis, and a cost analysis need not be performed. In limited situations, a cost analysis may be appropriate to establish reasonableness of the otherwise successful offeror's price. When contracting on a cost-reimbursement basis, evaluations shall include a cost realism analysis to determine what the government should realistically expect to pay for the proposed effort, the offeror's understanding of the work, and the offeror's ability to perform the contract. The contracting officer shall document the cost or price evaluation. (FAR 15.305(a)(1))

**Appendix II: Key Elements for Contracting  
Officers in Assessing Contractor Value Added**

<b>Element of framework</b>	<b>Description</b>
Technical and past performance analysis	The source selection records shall include an assessment of each offeror's ability to accomplish the technical requirements; and a summary, matrix, or quantitative ranking, along with appropriate supporting narrative, of each technical proposal using the evaluation factors. Cost information may be provided to members of the technical evaluation team in accordance with agency procedures. Additionally, the evaluation should take into account past performance information regarding predecessor companies, key personnel who have relevant experience, or subcontractors that will perform major or critical aspects of the requirement when such information is relevant to the instant acquisition. (FAR Part 15.305(a)(2))
Subcontracting plans	In negotiated acquisitions, each solicitation that is expected to exceed \$550,000 (\$1,000,000 for construction) and that has subcontracting possibilities, shall require a subcontracting plan. If the offeror fails to negotiate a subcontracting plan acceptable to the contracting officer within the time limit prescribed by the contracting officer, the offeror will be ineligible for award. (FAR 19.702(a)(1)&(2)). Each subcontracting plan must include percentage goals for using different types of small businesses, a statement of the total dollars planned to be subcontracted, a statement of the total dollars planned to be subcontracted to small businesses, and a description of the principal types of supplies and services to be subcontracted.(FAR 19.704(a))
<b>Contract pricing</b>	Contracting officers must purchase supplies and services from responsible sources at fair and reasonable prices. When prices are based on adequate price competition, no other information is generally needed. In other cases, more information may be needed. (FAR 15.402(a))
Cost accounting	When required, a disclosure statement must be submitted as a part of the offeror's proposal unless they have already submitted a statement disclosing the practices used in connection with the pricing of the proposal. (FAR 52.230-1(b)). Prime contractors or higher tiered subcontractors can be required to include subcontractor accounting practices in their disclosure statements (FAR 30.202-8(a)). DCAA provides audit services in assuring compliance with Cost Accounting Standards.
Cost and pricing data	The contracting officer shall require the prime contractor to submit cost and pricing data and a certificate that states that the data are accurate, complete, and current. Any subcontractor or prospective subcontractor should submit similar data and certification to the prime contractor or appropriate subcontractor tier. (FAR 15.403-4)
Information other than cost and pricing data	The contracting officer is responsible for obtaining information that is adequate for evaluating the reasonableness of the price or determining cost realism. The contracting officer may request other information to use in this evaluation, including, the prices at which the same item or similar items have previously been sold. (FAR 15.403-3)
Subcontract pricing	The contracting officer is responsible for the determination of price reasonableness for the prime contract, including subcontracting costs. The contracting officer should consider whether a contractor or subcontractor has an approved purchasing system, has performed cost or price analysis of proposed subcontractor prices, or has negotiated the subcontract prices before negotiation of the prime contract, in determining the reasonableness of the prime contract price. This does not relieve the contracting officer from the responsibility to analyze the contractor's submission, including subcontractor's cost or pricing data. (FAR 15.404-3)
DCAA	The contracting officer should request field pricing assistance when the information available at the buying activity is inadequate to determine a fair and reasonable price. The contracting officer must tailor requests to reflect the minimum essential supplementary information needed to conduct a technical or cost or pricing analysis. (FAR 15.404-2). DCAA's Financial Liaison Advisors provide financial advisory service support at customer sites to assist contracting officers in determining fair and reasonable contract prices. These services include market research and analysis of certified cost and pricing data and other information.
DCMA	DCMA can also provide requested assistance through technical analysis (i.e., engineering evaluation of proposed labor hours or material requirements) and special analyses (i.e., evaluations of specific cost elements, rates and factors, or, in some cases, estimating methodologies).

**Appendix II: Key Elements for Contracting  
Officers in Assessing Contractor Value Added**

<b>Element of framework</b>	<b>Description</b>
<b>Contract management</b>	
Audit services	DCAA, as the responsible audit agency, submits information and advice to the requesting activity based on the auditor's analysis of the contractor's financial and accounting records or other related data as to the acceptability of the contractor's incurred and estimated costs. DCAA may also perform other analyses and reviews that require access to the contractor's financial and accounting records supporting proposed and incurred costs. (FAR 42.101)
Contract administration	The contracting officer delegates many functions to a contract administration office. This office can be DCMA or another agency that offers a wide variety of administrative services. However, since the prime contractor is responsible for managing its subcontracts, this office's review of subcontracts is normally limited to evaluating the prime contractor's management of the subcontracts. Therefore, supporting contract administration shall not be used for subcontracts unless the Government otherwise would incur undue cost or successful completion of the prime contract is threatened. For major system acquisitions, the contracting officer may designate certain high-risk or critical subsystems or components for special surveillance in addition to requesting supporting contract administration. (FAR 42.201 and 42.202).
Consent to subcontract	The contracting officer may require consent for subcontracts to protect the government because of the subcontract type, complexity, or value, or because the subcontract needs special surveillance. These can be subcontracts for critical systems, components, or services. (FAR 44.201-1(a)). Notification submitted to the contracting officer should include a description of the supplies or services to be subcontracted, the type of subcontract to be used, the proposed subcontractor and proposed price, the subcontractor's current cost or pricing data, certificate of cost and pricing data, and the subcontractor's Disclosure Statement or Certificate to Cost. (FAR 52.244-2 (f)(1)).
Contractor purchasing system review	The objective of a contractor purchasing system review is to evaluate the efficiency and effectiveness with which the contractor spends government funds and complies with government policy when subcontracting. The review provides the administrative contracting officer a basis for granting, withholding, or withdrawing approval of the contractor's purchasing system. (FAR 44.301). Evaluation of the purchasing system pays special attention to items such as the degree of price competition obtained, methods of obtaining accurate cost or pricing data, and methods of evaluating subcontractor responsibility. (FAR 44.303).

Source: GAO analysis of the FAR.

# Appendix III: Comments from the Department of Defense



ACQUISITION,  
TECHNOLOGY  
AND LOGISTICS

OFFICE OF THE UNDER SECRETARY OF DEFENSE  
3000 DEFENSE PENTAGON  
WASHINGTON, DC 20301-3000

JAN 17 2008

Ms. Ann Calvaresi-Barr  
Director, Acquisition and Sourcing Management  
U.S. Government Accountability Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Ms. Calvaresi-Barr,

This is the Department of Defense (DoD) response to the GAO Draft Report GAO-08-269 "DEFENSE CONTRACTING: Contract Risk a Key Factor in Assessing Excessive Pass-Through Charges," dated December 19, 2007 (GAO Code 120668). Detailed comments on the report are enclosed.

Sincerely,

Shay D. Assad  
Director, Defense Procurement  
and Acquisition Policy

Enclosure:  
As stated



**GAO DRAFT REPORT DATED DECEMBER 19, 2007  
GAO-08-269 (GAO CODE 120668)  
“DEFENSE CONTRACTING: CONTRACT RISK A KEY FACTOR IN  
ASSESSING EXCESSIVE PASS-THROUGH CHARGES”**

**DEPARTMENT OF DEFENSE COMMENTS  
TO THE GAO RECOMMENDATION**

**RECOMMENDATION 1:** The GAO recommended that the Secretary of Defense direct the Director of Defense Procurement and Acquisition Policy (DPAP) require contracting officials to take risk into account when determining the degree of assessment needed. Risk factors to consider include whether (1) the contract is completed; (2) the contract type requires the government to pay a fixed price or costs incurred by the contractor; and (3) any unique circumstances exist, such as requirements that are urgent in nature. (p. 22/GAO Draft Report)

**RECOMMENDATION 2:** The GAO recommended that the Secretary of Defense direct the DPAP require contracting officials to document their assessments of contractor value added in the contract files. (p. 22/GAO Draft Report)

**RECOMMENDATION 3:** The GAO recommended that the Secretary of Defense direct the DPAP involve DCAA and DCMA in facilitating assessments as appropriate. (p. 22/GAO Draft Report)

**DoD RESPONSE:** Concur with all 3 recommendations. As discussed with the GAO representatives at the initiation of this review, DPAP intends to issue extensive guidance in the Defense Federal Acquisition Regulation Supplement (DFARS), Procedures Guidance and Instructions (PGI) to ensure a clear understanding of the new DFARS rule on Excessive Pass-Through Charges. The PGI guidance will provide detailed guidance on a multitude of issues surrounding the review of excessive pass-through charges and will include: assessment of risk factors, documentation of assessments of contractor value added, and will continue the current emphasis to obtain DCMA and DCAA assistance in assessing the existence of excessive pass-through charges.

The initial interim DFARS rule is in the process of being revised based on public comments. We anticipate issuance of a second interim rule in February 2008 to obtain additional public comments to ensure the revisions have resolved the confusion expressed in the initial public comments and feedback from field organizations. After a 60 day public comment period, we expect a final rule to be issued by August 2008. Once a final version of the rule is known, DPAP will set up a PGI case to provide extensive guidance to supplement the regulation. We anticipate a revised PGI to be issued in October 2008. In the interim, DPAP Cost, Pricing and Finance division is providing real-time assistance and guidance, and each field organization has a headquarters point of contact when guidance is required.

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